STATE OF MICHIGAN
IN THE SUPREME COURT

In re Request for Advisory Opinion
Regarding constitutionality of 2011 PA 38

Docket No. 143157

AMICUS CURIAE BRIEF OF THE INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA (UAW)

ORAL ARGUMENT REQUESTED

Michael F. Saggau (P35326)
International Union, UAW
8000 E. Jefferson Avenue
Detroit, MI 48214
(313) 926-5216
(313) 925-5240 (fax)
msaggau@uaw.net

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STATEMENT OF JURISDICTION

On May 31, 2011, Governor Rick Snyder requested that this Court issue an advisory opinion under the authority of Const 1963, art 3, § 8. On June 15, 2011, this Court granted the Governor's request and requested amicus curiae briefs from groups interested in the determination of questions presented.

STATEMENT OF QUESTIONS PRESENTED

1. Does reducing or eliminating the statutory exemption for public-pension incomes as described in MCL 206.30, as amended, impair accrued financial benefits of a "pension plan [or] retirement system of the state [or] its political subdivisions" under Const 1963, art 9, § 24?

   Amicus Curiae UAW answers, "yes."

2. Does reducing or eliminating the statutory tax exemption for pension incomes, as described in MCL 206.30, as amended, impair a contract obligation in violation of Const 1963, art 1, § 10, or US Const, art I, § 10?

   Amicus Curiae UAW answers, "yes."

[Amicus Curiae does not address the following questions 3 and 4 in this brief]

3. Whether determining eligibility for income-tax exemptions on the basis of total household resources, or age and total household resources, as described in MCL 206.30(7) and (9), as amended, creates a graduated income tax in violation of Const 1963, art 9, § 7.

4. Whether determining eligibility for income-tax exemptions on the basis of date of birth, as described in MCL 206.30(9), as amended, violates equal protection of the law under Const 1963, art 1, § 2 or the Fourteenth Amendment of the United States Constitution.

INTEREST OF AMICUS CURIAE

The International UAW, United Automobile, Aerospace, and Agricultural Workers of America ("UAW") submits the following Brief as Amicus Curiae. The UAW is an international labor union, headquartered in Detroit, Michigan, consisting of approximately 1000 local unions and more than a million active and retired members and their families. The UAW, with its affiliated Local Union 6000, represents approximately 17,000 State of Michigan employees, including workers in every State of Michigan department and every county of the state. The UAW and Local 6000 represent those workers in collective bargaining with their employer, the State of Michigan, advise employees with respect to their benefits, provide representation in grievance proceedings, and assist them resolving workplace health and safety issues.

UAW members participate in the pension plan set forth in the State Employees Retirement Act, MCL 38.1 et seq ("SERA"). SERA, prior the enactment of 2011 PA 38 by the Michigan Legislature, provided a tax exemption with respect to pension payments made by the SERA retirement system. 2011 PA 38 terminated that tax exemption for some employees and retirees, and limited it for others.

Since its inception, the UAW has been active in protecting the retirement benefits of its members, in collective bargaining, in contract administration, and in court proceedings. In this Court's June 15, 2011 Order in this advisory opinion matter, this Court invited interested parties to submit amicus briefs. The UAW, by virtue of its representation of State of Michigan workers who participate in the SERA retirement system, is an interested party. The UAW submits this Amicus Brief to assist the Court in determining whether state employees participating in SERA have contractual rights under that statute, and whether those rights were impaire

INTRODUCTION

On May 31, 2011, Governor Rick Snyder asked the Michigan Supreme Court to issue an advisory opinion on the question of whether 2011 PA 38 violated certain federal and state constitutional protections.[1] On June 15, 2011, this Court granted the Governor's request and invited briefing by interested parties. This Amicus brief by the UAW addresses only one of those questions:

> Whether reducing or eliminating the statutory exemption for pension incomes as described in MCL 206.30, as amended, impairs a contractual obligation in violation of Const 1963, art 1, § 10 or the U.S. Const, art 1, § 10(1).

The UAW addresses a legal issue not addressed in the briefs filed by the Attorney General: Whether retirees who participate in the State Employees Retirement Act ("SERA")[2] retirement system have a contractual right, under the terms of SERA itself, to the pension tax exemption promised them in that statute since 1943, independent of and in addition to their rights under Article 9 of the Michigan Constitution.

Amicus UAW agrees that, as set forth in the amicus curiae brief filed by other interested amici,[3] that: 1) the tax exemption component of the deferred compensation promised in MCL 38.40 is protected by Article 9, § 24 of the Michigan Constitution; and 2) the attempt to rescind that tax exemption is an impairment of contract under Article 1,

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[1] The Attorney General, in his Brief on Appeal of Attorney General Bill Shuette in Support of the Validity of 2011 PA 38, asks for a determination that 2011 PA 38 is "constitutional in all respects" (see p. viii). This court, however, has not requested briefing on all the potential constitutional infirmities of 2011 PA 38, but only on the four constitutional issues listed in this Court's June 15, 2011 order.

[2] See MCL 38.1, et seq.

[3] See Amicus Curiae Brief of Michigan State Employee Retirees Association Coordinating Council, Michigan Federation of Chapters of National Active and Retired Federal Employees Association, and AARP (hereafter referred to "MSERA Amicus Brief").

§ 10 of the Michigan Constitution and Article 1, § 10 of the United States Constitution. (See MSERA Amicus Brief, pp. 7-44.)

The Brief of the Attorney General in Support of Validity[4] makes various arguments that the term "accrued financial benefits", as used in Article 9, § 24 of the Michigan Constitution, should not be read to include the MCL 38.40 tax exemption component of SERA deferred compensation benefits. As the MSERA Amicus Brief explains, that view is incorrect. The UAW files this Brief to show that, even if the tax exemption component of SERA were not an "accrued financial benefit" (and even if Article 9, § 24 had never been adopted), the terms of SERA itself create a binding obligation and require the State of Michigan to honor the promised SERA pension tax exemption.[5]

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[4] The Brief on Appeal of Attorney General Bill Shuette In Support of the Validity of 2011 PA 38 will be referred to in this Brief as the "Brief of Attorney General in Support of Validity", and the Brief of Attorney General Arguing that 2011 PA 38 is Unconstitutional as "Brief of the Attorney General Arguing Unconstitutional".

[5] Much of the UAW's argument with respect to SERA is applicable to tax exemption components of other governmental pensions provided by Michigan state and local governments, but the UAW specifically addresses only SERA in this Brief.

STATEMENT OF FACTS

In May, 2011, the Michigan Legislature passed, and Governor Rick Snyder signed, a bill that purported to partially rescind the tax exemption that had been a part of the pension benefit promised to State of Michigan employees participating in the SERA retirement system throughout their employment by the State.[6]

The tax exemption component of the SERA deferred compensation benefit has been a part of State employees' compensation for sixty-eight years, since SERA was enacted by the Michigan Legislature in 1943. At that time, as Michigan government entered the modern era, it sought to attract professionals to provide crucial government services to the citizens of Michigan. Members of UAW Local 6000 are among the workers the State of Michigan recruited to provide those services. These employees spent their careers in some of the most difficult, but most important jobs in Michigan. They include nurses, doctors, teachers, secretaries, probation and parole officers, social workers, mental health workers and vocational teachers.

To attract and retain professionals to work in these difficult, but crucial jobs, the Michigan Legislature enacted the SERA in 1943. The SERA retirement system covers State employees who hold permanent positions in the Michigan state civil service. The 1943 Act detailed the retirement benefits those workers would receive. The retirement benefits detailed in SERA include two primary components: 1) A monthly pension calculated by multiplying a set factor times final average compensation (and for

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[6] See MCL 38.40 and MCL 206.30,, as amended by PA 2011, No. 38. The 2011 legislation also purported to partially terminate the tax exemption components set forth in several other pension statutes, the Public School Employees Retirement Act, at MCL 38.1346; the Michigan Legislative Retirement Act, at MCL 38.1057, the city Library Employees' Retirement System Act, at MCL 28.705, and the Judges Retirement Act, at MCL 38.2670. The UAW *Amicus* Brief specifically addresses only the termination of the tax exemption component of the SERA pension.

employees hired after 1996, a defined contribution plan), and 2) a tax exemption which provided that the monthly pension would be exempt from state taxation (see MCL 38.40).[7]

The tax exemption component of the deferred compensation provided by SERA was codified at MCL 38.40. That original 1943 tax exemption provision, except for a few minor and insubstantial changes, continued unchanged until May, 2011. Prior to the 2011 amendments, MCL 38.40 provided as follows:

> **Exemption from taxation of right to pension, annuity, allowance, etc.; Applicability to right to pension, annuity, allowance, etc., of public employee retirement benefit protection act.**
>
> Sec. 40. The right of a person to a pension, an annuity, a retirement allowance, any optional benefit, any other right accrued or accruing to any person under the provisions of this act, the various funds created by this act, and all money and investments and income of the funds, are exempt from any state, county, municipal, or other local tax.
>
> P.A. 1943, Eff. July 30, 1943

The SERA pension tax exemption partially compensates retirees covered by the SERA retirement system for the reduced compensation received over the past many decades to individuals who chose public service as their life's work. As the Michigan House Fiscal Agency noted in a 2008 report, "Michigan State employees with college degrees tend to earn appreciably less than their counterparts in the private sector."[8] (Most employees of the State of Michigan have college degrees.)[9] For example, the average annual salary for employees with a Masters Degree was $60,926 for Michigan State

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[7] SERA also provides a tax exemption for retirement payments from the defined contribution plan enacted in 1996, which is known as the "Tier 2" plan. That tax exemption was not terminated by 2011 PA 38.

[8] See Exhibit A, Civil Service Salary and Benefit Comparisons excerpts, p. 1.

[9] See Exhibit A, Civil Service Salary and Benefit Comparisons excerpts, p. 1.

employees, and $97,937 for private sector employees. For employees with a Bachelor's degree, the differential was $51,646 for Michigan State employees and $71,378 for private sector employees. As the 2008 House Fiscal Agency report summarized:

> . . . for all educational levels, State employees – on average – receive lower earnings than their private sector counterparts . . .State employees with Masters degrees make an average of 37.8 percent less than private sector employees; State employees with Bachelor's degrees make an average of 27.6 percent less than private sector employees.
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> (See Exhibit A, Civil Service Salary and Benefit Comparisons excerpts, p. 26)

As noted below, state employers frequently include a tax exemption component in the pensions they promise their employees, because the tax exemption benefit is a cost effective method by which a governmental employer can provide deferred compensation which – in total – is competitive with the private sector. (See below, Argument II B)

The State of Michigan, acting in its capacity as an employer, regularly assured its employees covered by SERA that their pension benefit included a tax exemption. For example, a booklet prepared by the Michigan State Office of Retirement Services, entitled "Retirement Readiness, A Two Year Countdown" advised State employees considering retirement to "estimate how much retirement income you will receive", and whether the income stream will be between 60-80 percent of preretirement income. The booklet assured State employees that:

> **Your pension is exempt from Michigan and local income taxes.**
>
> (Emphasis added) (See Exhibit B, "Retirement Readiness" booklet excerpts, p. 34)

Similarly, another on-line retirement planning booklet provided by the State to its employees also assures them that:

> **Your pension is exempt from Michigan and local income taxes.**

(Emphasis added) (See Exhibit C, "After You Retire: What Every Pension Recipient Should Know")[10]

The State also furnished its employees with a booklet entitled "Retirement Guidelines", and told employees that "The Retirement Guidelines" booklet "should be carefully reviewed prior to retirement". The Guidelines booklet, under the heading "Tax Obligations", informed State employees that:

> **Pensions paid by the State Employees' Retirement System are exempt from Michigan State and city income tax. Although you are exempt from paying Michigan income tax, you must file state and city (if applicable) tax returns acknowledging your state pension and claiming your exemptions.**
>
> (Emphasis added)(See Exhibit C, April 15, 2002 letter to UAW Local 6000 retiree Robert Sisler from the State of Michigan Office of Retirement Services, and Exhibit D, August 2001 Retirement Guidelines excerpt, p. 29.)

These are but examples of the countless assurances the State of Michigan gave its employees, over the past several decades, that the SERA pension they were working toward included the SERA tax exemption.

In 2011, the State partially rescinded the MCL 38.40 tax exemption component of the pensions provided under the terms of SERA. The Legislature passed, and Governor Rick Snyder signed, 2011 PA 38. This legislation purports to rescind the tax exemption component of the SERA pension set forth, even for State employees who had already retired. (At least temporarily, the SERA tax exemption remains in place, or partially in place, for limited sub-sets of employees.)[11]

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[10] See www.michigan.gov/ORSstateDB, p. 29

[11] See MSERA Amicus Brief, pp. 6-7.

ARGUMENT

I. SERA CREATES CONTRACTUAL DEFERRED COMPENSATION OBLIGATIONS, IN ADDITION TO AND INDEPENDENT OF THE CONTRACTUAL OBLIGATIONS CREATED BY ARTICLE 9, § 24 OF THE MICHIGAN CONSTITUTION.

A. The Applicable Standard, in Determining Whether a State Statute Creates a Contractual Obligation, is Whether the Language of the Statute and the Surrounding Circumstances Demonstrate the Creation of Contractual Rights.

The United States Constitution prohibits the State of Michigan from enacting any law "....impairing the Obligation of Contracts...". As this Court noted, the Michigan Constitution contains a "virtually identical" prohibition.[12] See *In re Certified Question(Fun 'N Sun RV, Inc v. Michigan)*, 447 Mich. 765, at p. 776 (1994), 527 N.W.2d 468. These constitutional provisions bar a state legislature from passing legislation impairing contractual relations between private parties. They also bar a state legislature from passing legislation modifying the state's own contractual promises. See *United States Trust Co. of New York v. New Jersey*, 441 U.S. 1, at p. 17 (1977):

> It long has been established that the Contract Clause limits the power of the States to modify their own contracts as well as to regulate those between private parties.

A state statute will be treated as a contract when the language of the statutes, and the surrounding circumstances, indicate an intent to create contractual rights:

> In general, a statute is itself treated as a contract when the language and circumstances evince a legislative intent to create private rights of a contractual nature and enforceable against the state.
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> *United States Trust Co. of New York v. New Jersey*, 441 U.S. 1, at p. 17, n. 14.

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[12] See Article 1, Section 10 of the U.S. Constitution, and Article 1, Section 10 of the Michigan Constitution.

This Court, necessarily, uses the same standard when determining whether a Michigan statute creates contractual obligations. See *In re Certified Question (Fun 'N Sun RV, Inc) v. Michigan*, 447 Mich. 765, at p. 778, 527 N.W.2d 468, citing *U.S. Trust Co. of New York v. New Jersey,* 441 U.S. 1, p. 17, n. 14. See also *Studier v MPSERB,* 472 Mich. 642, at p.663 (2005), 698 N.W.2d 350, citing to *In re Certified Question (Fun 'N Sun RV, Inc)*, above.

In applying this standard, the United States Supreme Court has noted that if a state statute specifically states that it is a "contract", or a "covenant", or the statute requires the execution of a contract, then it is clear that the statute creates a contractual obligation. See *Dodge v. Board of Education of City of Chicago*, 302 U.S. 74, at p. 79 (1937): "If [the statutory language] provides for the written execution of a contract on behalf of the state, the case for an obligation binding on the state is clear.

The U.S. Supreme Court has also held that contracts can also be created by statutes that do not provide for execution of a written agreement, and do not expressly use the word "contract", or "covenant. This is hornbook contract law: if a state enacts legislation promising certain benefits to induce a private party to takes certain action, and the private party does so, consideration is provided and a contractual obligation is formed. For example, the Michigan Legislature desired the construction of a railway line from Detroit to Lake Michigan. To induce a railroad company to build lay that railway, the Michigan Legislature passed legislation stating that the railroad company's, its tax obligation would henceforth be limited to 1% of its capital stock, "...in lieu of all other taxes." *Powers v. Detroit, Grand Haven, and Milwaukee Railway Company*, 201 U.S. 543, at p. 556 (1906).

In that case, the State of Michigan argued, as it does here, that the promised statutory tax exemption was a "...mere gratuity, which can be withdrawn at any time...". See *Powers v. Detroit, Grand Haven, and Milwaukee Railway, Id.*, at p. 557. The U.S. Supreme Court, after delving into the surrounding facts, disagreed. The Supreme Court noted that the railroad company, induced by the promised tax treatment, built the railway. The state reaped the benefits, and thereby became contractually obligated honor to its legislative promise. The Supreme Court explained the difference between a general statute, which creates no contractual obligation, and a "contractual" statute. The determinative question, the court instructed, is whether there was:

> ...a counter-obligation, service, or detriment incurred, that properly could be regarded as consideration for the supposed contract. [citations omitted].
>
> *Powers v. Detroit, Grand Haven, and Milwaukee,* Id., 201 U.S. at p. 558

As Amicus UAW shows below, application of the "language and circumstances" standard of *United States Trust Co. of New York v. New Jersey* establish that SERA creates a contractual obligation to provide the deferred compensation promised in that statute.

B. Virtually All State Courts Hold That the Language and Circumstances of Statutory Deferred Compensation Promises by Governmental Employers Create Binding Obligations.

Virtually all state courts which have addressed this issue during the last forty years have ruled that statutory deferred compensation promises by governmental

employers create binding obligations.[13] The reason is simple. The courts have recognized that where a state, competing in the labor market as an employer, promises specific deferred compensation to induce workers to choose state employment over private sector employment, the statutory deferred compensation promise is contractual. As the Oregon Supreme Court ruled with respect to a state pension statute similar to SERA:

> Employee pension plans, whether established by law or contract, create a contractually based vested property interest which may not be terminated by the employer, *except prospectively*. The employer offers payment of future pension benefits as part of compensation for work currently performed. Employees accept and earn such future benefits by performing current labor.
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> *Hughes v. State of Oregon*, 838 P.2d 1018, at p.1029 (1992).

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[13] See: *Stork v. State of California*, 133 Cal. Rptr. 207, at p. 208 (California 1977); *Police Pension and Relief Board of City and County of Denver v. Bills*, 366 P.2d 581 at p. 583 (Colorado, 1961); *Withers v. Register,* 269 S.E.2d 431, at p. 432 (1980); *State ex rel. O'Donald v. City of Jacksonville Beach*, 142 So.2d 349, at pp. 354-355 (Florida, 1962); *Hanson v. City of Idaho Falls,* 446 P.2d 634, at p. 636 (Idaho, 1968); *City of Frederick v. Quinn,* 371 A.2d 724, at p. 726 (1977); (Maryland Court of Appeals, holding that pension vested as it was "proratedly earned"); *Christensen v. Minneapolis Mun. Employees Retirement Bd.*, 331 N.W.2d 740, p. 747 (1983) (Minnesota Supreme Court, holding that promissory estoppel prohibited changes to pension rights after public employee had retired.) (1983); *Sullivan v. State of Montana Teachers' Retirement Board,* 571 P.2d 793, p. 795 (1977) (Supreme Court of Montana rules that "In Montana, retirement benefits in the teachers retirement system are a matter of contract right."); *Pierce v. State of New Mexico*, 910 P.2d 288, at p. 299 (1995) (Supreme Court of New Mexico, which examined "language and circumstances" of state pension statutes to determine if they created contractual rights.); *Simpson v. North Carolina Local Government Retirement System*, 363 S.E.2d 90, at p. 94 (1987) *aff'd per curiam*, 372 S.E. 2d 559 (1988) (North Carolina Supreme Court, holding that employees "...had a contract to rely on the terms of the plan as those terms existed at the moment their retirement benefits became vested."); *Hughes v. State of* Oregon, 838 P.2d 1018, p. 1027 (1992) (Oregon Supreme Court, holding that state pension statute "...is a contract between the state and its employees."); *Weaver v. Evans*, 495 P.2d 639, p. 648 (1972) (Washington Supreme Court, holding stating that Washington adheres to the contract of employment vested right "theory relative to public pension systems..."); *Dadisman v. Moore*, 384 S.E.2d 816 at 826-27 (West Virginia, 1988) (". . .[r]etired and active PERS plan participants have contractually vested pension rights created by the pension statute, and such property rights are enforceable and cannot be impaired or diminished by the state.").

The primary variance, within this national consensus, is whether those contractual rights attach at the beginning of employment,[14] upon accruing benefits while employed,[15] or upon retirement[16]. Even those state courts which have balked at adopting the national consensus described above, however, have acknowledged that promised pension benefits cannot be changed after an employee retires. See *Spiller v. State*, 627 A.2d 513, at p. 514 (1993), permitting changes to retirement benefits "for employees to whom benefits are not then due."

There are rare exceptions to this rule. For example, if a state pension statute specifically states that it does not create any contractual rights, then it does not. See *Pierce v. State of New Mexico,* 910 P.2d 288, at p. 299 (1995), examining a state pension statute which stated that "...nothing done hereunder shall create any contract rights..." SERA contains no such language.

In determining whether a particular pension statute or local government pension enactment creates a binding obligation, the courts have, consistent with the standard articulated by the U.S. Supreme Court in *United State Trust Co., supra,* looked to the terms of the applicable statute and the surrounding circumstances.

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[14] Under the "California Rule", contractual pensions right attach at the time of employment. Reasonable modifications can be made during employment, so long any disadvantages resulting from such modifications are offset by comparable advantages to affected employees. Under this rule no changes may be made after retirement. *Stork v. State of California*, 133 Cal.Rptr.. 207, at p. 208 (1976); *Police Pension and Relief Board of City and County of Denver v. Bills*, 366 P.2d 581 at p. 583 (Colorado, 1961).

[15] See *City of Frederick v. Quinn*, 371 A.2d 724, at p. 726, holding that "...pension benefits [employees] have earned by satisfactory service cannot be divested."

[16] See *State ex rel O'Donald v City of Jacksonville Beach*, 142 So.2d 349, at pp. 354-355.

C. SERA Contains Clear and Detailed Deferred Compensation Promises Which Create Contractual Obligations.

The pension benefits the State of Michigan promised employees in SERA is a contractual obligation as a matter of basic contract law. The State offered detailed, defined deferred compensation benefits to induce Michigan citizens to enter state employment. SERA participants provided consideration for that promise in the form of decades of service in justifiable reliance on that promise.

There is nothing vague or uncertain about the pension benefits promised by the State in SERA. SERA is a comprehensive modern pension statute that sets forth detailed provisions under which employees become eligible to participate, earn credited service, forfeit credit service, accrue retirement benefits under a final average compensation formula, and retire.[17] For example:

> A member who is 60 years of age or older and has 10 or more years of credited service or a member who is 60 years of age or older and has 5 or more years of credited service . . . may retire upon written application to the retirement board . . . Beginning on the retirement allowance effective date, he or she shall receive a retirement allowance computed according to § 20(1)
>
> MCL 38.19 (emphasis added)

[17] SERA: defines eligible participants (MCL 38.13); defines credited service to be included in the pension formula (MCL 38.17 and 38.18); describes the circumstances under which employees may purchase service credits (MCL 38.17); describes situations under which employees will forfeit their of credited service (MCL 38.16(1), and (2)); defines in detail the age and service requirements for retirement eligibility (MCL 38.19, 38.19a, 38.19b, 38.19c, 38.19d, 38.19f, 38.19g, 38.19i); defines the formula by which retirees' pension payments are calculated (MCL 38.20), provides for a minimum retirement allowance amount (MCL 38.20a), and provides for optional survivor benefits (MCL 38.31-32).

> Upon his or her retirement, as provided for in § 19, 19a, 19b, 19c, or 19d, a member shall receive a retirement allowance equal to the member's number of years and a fraction of a year of credited service multiplied by 1-1/2% of his or her final average compensation.
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> M.C.L.A 38.20(1) (emphasis added)[18]

SERA is fundamentally different than a statute of general application, which citizens instinctively understand not to create any contractual application. No Michigan taxpayer, for example, has any contractual right to expect that the State will not change the current generally applicable income tax rate. All understand the general tax code provisions to involve the relationship between the State, as government, and its taxpayer citizens. In enacting SERA, however the State acted as an employer, by making a specific deferred compensation offer to a specific group – the skilled workers it sought to attract and retain as employees.

State courts examining similar comprehensive state pension system statutes covering public employees have found those statutes to establish a contractual obligation to provide the promised benefits (without any need to rely on state constitutional provisions). This consensus is based on the recognition that the statutory pensions offered by the State as an employer are part of the earned but deferred compensation of their employees. See, for example, *Hughes v. State of Oregon*, 838 P.2d 1018, at p. 1029 (1992), finding that Oregon's statewide Public Employees Retirement System statute created contractual obligations because the state, as employer, "offers payment of future benefits as part of compensation for work currently performed." See also *Dryden v. Board of Pension Commissioners*, 59 P.2d 104, at p. 106 (California,1936): "The pension provisions of the city charter are an integral portion of the contemplated

[18] As set forth in the MSERA Amicus Brief, SERA has also provided, since 1997, a "Tier 2" defined contribution plan.

compensation set forth in the contract of employment between the city and the members of the police department, and are an inescapable part of that contract." See also *Bakenhus v. City of Seattle*, 296 P.2d 536, at p. 538 (1956): ". . . a pension granted to a public employee is not a gratuity but is deferred compensation for services rendered."

The recognition that pension promises of governmental employers are part of earned compensation is nearly universal. See Footnote 13, above. As State operations expanded, governmental employers recruited and retained skilled workers by promising compensation packages that included *deferred* compensation. As the Supreme Court of North Carolina noted, consistent with the settled national consensus described above:

> "A pension paid a governmental employee ... is a deferred portion of the compensation earned for services rendered" If a pension is but deferred compensation, already in effect earned, merely transubstantiated over time into a retirement allowance, then an employee has contractual rights to it. The agreement to defer to compensation is the contract. Fundamental fairness also dictates this result. A public employee has a right to expect that the retirement rights bargained for in exchange for his loyalty and continued services, and continually promised him over many years, will not be removed or diminished. Plaintiffs, as members of the North Carolina Local Government Employees' Retirement System, had a contractual right to rely on the terms of the retirement plan as these terms existed at the moment their retirement rights became vested.
>
> *Bailey v. State of North Carolina,* p. 60

The promised compensation induced skilled workers to work for state government. See *Police Pension and Relief Board of City and County of Denver v. Bills*, 366 P.2d 581 at p. 583 (1961) ". . . such is the material inducement to the employees to remain in the employment of the government. See also *Yeazell v. Copins,* 402 P.2d 541 (1965); *Hanson v. City of Idaho Falls* 446 P.2d 634, at pp. 636-637 (1968); *City of Frederick v. Quinn*, 371 A.2d 724, at p. 726, (1983); *Simpson v. North Carolina Local Government Retirement System*, 363 S.E.2d 90 at p. 94 (1987),

Governmental employers offered competitive pension benefits because state they were competing with private employers for workers, and public employers typically paid smaller salaries than private employers. As the Supreme Court of Arizona stated in *Yeazell v. Copins*, 402 P.2d 541 (1965):

> . . . public employment seldom pays on the same scale as private enterprise for the same services . . .Government, with its various public agencies, enters into areas on a scale so vast and to such an extent as to have scarcely been conceived fifty years ago. To the end that public service may be improved, the legislature has authorized the state and its various subdivisions to establish retirement and pension plans. These plans are not dependent upon the benevolence of the employing agency but are prescribed by the legislature and the conditions of the employment, as related to retirement from public service, are provided by general law. Retirement is, as in private industry a valuable part of the consideration for the entrance into and considerations in public employment.
>
> *Yeazell,* p. 545.[19]

This reasoning applies with equal force to the question of whether the deferred compensation promised under the terms of SERA benefits are an earned, contractual part of State employees' pensions. The SERA deferred compensation benefits promised over the last sixty-eight years induced Michigan citizens to enter into and remain in State service through retirement, despite the generally lower salary levels paid to State workers compared to their private sector counterparts. (See Statement of Facts, above.) Those employees furnished consideration for the promised SERA retirement benefits by decades of service in the states employ. Amicus UAW respectfully urges that this Court rule that SERA creates binding contractual deferred compensation obligations.

D. The Attorney General is Incorrect in Asserting that Statutory Governmental Deferred Compensation Benefits "are not vested rights, but gratuities".

The Brief of Attorney General in Support of Validity, at p. 5, asserts that, but for Article 9, § 24 of the Michigan Constitution, statutory pensions promised to Michigan public employees in SERA could be terminated at any time, even after retirement. This assertion is incorrect. In making this argument, the Attorney General cites this court's 1948 decision in *Brown v. City of Highland Park*, 320 Mich. 108, 30 N.W.2d 798 (1948). In *Brown*, however, this Court based decision on the particular facts involved. It did not announce a blanket rule that governments could renege on pension promise at will. As this Court stated in *Brown*:

> The question for us to determine in this case is not the power or capacity of the parties, which power and capacity are not disputed; what we must determine is whether or not under the circumstances disclosed in the record a contract is to be considered as having been entered into between the parties binding upon each and providing for a pension in the amount claimed by plaintiffs.
>
> *Brown*, 320 Mich. at p. 113 (emphasis added)

The *Brown* case involved a 1918 City of Highland Park city charter provision which stated that disabled or retired police and firemen would receive $50 per month. *Brown*, 320 Mich. at p. 110. As the Michigan Supreme Court emphasized in that case, the Highland Park city charter which provided for the $50 monthly payment specifically provided that the charter was subject to amendment. In 1943, the Highland Park city council passed a resolution permitting the retirement of Brown, a Highland Park police officer, under the $50/month charter provision. In 1945, however, the city amended the charter to decrease the monthly payment payable to retired and disabled police officers and firemen, including those that had already retired.

This court held in *Brown* that the retired City of Highland Park police officers had no contractual right to the $50/month payment for two reasons: 1) a survey of current law in other states indicated that the then-current consensus was that governmental pensions were mere gratuities that could be modified or terminated at the pleasure of the employer;[20] and 2) the fact that the City Charter which provided for the pension specifically provided that it could be amended, and so employees accepted employment with the city "with full knowledge imputable to him that the charter provisions could be amended." *Brown v. City of Highland Park,* 320 Mich. at p. 115.

Neither of the factors the *Brown* court relied upon are present here.

1) As Set Forth Above, the National Consensus Among State Courts is that Statutory Pension Promises to State Employees Creates a Binding Obligation

As noted above, nearly all jurisdictions now hold that a statutory deferred compensation promise by a governmental employer to its employees creates a binding contractual obligation. The Attorney General, in his assertion to the contrary, relies on the now discarded "gratuity" theory. The rule that had held sway in previous centuries, and even into the first half of the twentieth century, was that a pension promise by a governmental employer, no matter how clear, detailed, or exact, could be revoked – even after retirement – at the pleasure of the governmental employer. The basis for this now-discarded theory, noted by this court in the 1948 *Brown v. City of Highland Park*, was the notion that governmental employers were the equivalent of medieval monarchs with

[20] After surveying the state of the law across the nation in 1948, this court noted that: "We are convinced that the majority of cases in other jurisdictions established the rule that a pension granted by public authorities is not a contractual obligation, that the pensioner has no vested right, and that a pension is terminable at the will of a municipality, at least while acting within reasonable limits." *Brown v. City of Highland Park*, 320 Mich. at p. 114.

respect to their employees, and could therefore grant or withhold promised pensions at their whim. As the Supreme Court of Illinois described this view in a 1927 decision:

> A pension is a bounty springing from the appreciation and graciousness of the sovereign, and may be given or taken away at its pleasure.
>
> *Donovan v. Retirement Board Police and Policemen's Annuity and Benefit Fund,* 158 N.E. 220, at p. 221 (1927)

With the advent of modern governmental pension systems such as SERA, and a recognition that state and local governmental employers must honor their contracts, this "pleasure of the sovereign" rule has been discarded by state courts throughout the United States.

As the Supreme Court of North Carolina noted in 1987:

> . . .a majority of courts have in recent years abandoned the common law gratuity theory in favor of an approach which accords more protection to such pension rights.
>
> *Simpson v. North Carolina Government Employees' Retirement System*, 363 S.E.2d 90, at p. 93 (1987).

The Supreme Court of Pennsylvania explained the reason for the theory that pensions were mere gratuities, and the reason that theory has been abandoned:

> The concept of pensions has come down through the centuries wearing a cloak of monarchial dispensation. . .However, despite ceremony an pronunciamento, the pensioner obtained no vested right to the proclaimed pension. In fact, he could not be any more assured of a continuation of the pension than he could be assured that his head would remain on his shoulders if he should displease his absolutist benefactor. <u>But the pension of today is not a grant of the Republic nor in this case is it a gift of the City Fathers. It is the product of mutual promises between the pensioning authority and the pensioner; it is the result of contributions into a fund which exists for the single purpose of pensions.</u>

Hickey v. Pittsburgh Pension Board, 106 A.2d 233 at p. 235 (1954)[21]

The national consensus across the United States is now that governmental pension promises create binding obligations. See Argument I and Footnote 11.

2) The Terms of SERA Do Not Permit the State to Terminate the Deferred Compensation Provided for in that Statute.

The second factor relied upon by this court in *Brown v city of Highland Park* was that the City of Highland Park city charter in which the pension promise was contained stated that the charter could be amended by the City of Highland Park. Therefore, this Court ruled in *Brown*, the employees had "full knowledge imputable" that the City's $50/month promise was not binding See *Brown*, 320 Mich. at p. 111 and p. 115.

This is still the law. If a pension statute specifically states that it does not create contractual rights, or that the promised benefits may be terminated, no contractual rights arise. (See *Pierce v. State of New Mexico*, 910 P.2d 288, at p. 299 (1995)). SERA contains no such provision. Instead, SERA states in exacting detail exactly what deferred compensation benefits employees will receive, and when. Amicus UAW is unaware of any State of Michigan assertion to its employees, since the 1943 enactment of SERA, verbal or written, in which the State claimed the right to modify or terminate SERA pension benefits. Clearly, there is no "full knowledge imputable" to SERA participants that the State could renege on its pension promise.

[21] See also *Yeazell v. Copins*, 402 P.2d 541, at p. 543 (1965), noting the "generally accepted theory that pensions are part of the compensation of an employee to which, under ordinary circumstances, he is as much entitled as he is to the wages paid him for the work he has actually performed.

II. THE TAX EXEMPTION COMPONENT OF SERA IS PART OF THE CONTRACTUALLY PROTECTED DEFERRED COMPENSATION BENEFIT

As set forth above, the terms of SERA create a contractual obligation to provide the deferred compensation promised in that statute, independent of and in addition to the contractual obligation created with respect to all Michigan public employee pension plans under Article 9, § 24 of the Michigan Constitution. The remaining question is whether the promised deferred compensation includes the SERA tax exemption which was set forth at MCL 38.40 from 1943 through 2011. As set forth below, the SERA tax exemption is and always has been an integral component of State employees' compensation.

As set forth in the MSERA Amicus Brief, and the Brief of Attorney General Arguing Unconstitutional, the question of whether the SERA tax exemption is contractually protected under Article 9, § 24 turns on the question of whether the SERA tax exemption is an "accrued financial benefit", as that term is used on Article 9, § 24. The question of whether the SERA pension statute itself creates a binding obligation to provide the promised pension tax exemption is determined the "language and circumstances" of SERA. See *United States Trust Co. of New York v. New Jersey*, 443 U.S. 1, at p. 17, n. 14. As set forth below, the applicable language and circumstances establish that SERA tax exemption is a contractual obligation.

A. The SERA Pension Tax Exemption Was Promised by the State, as an Employer, to Attract and Retain Skilled Employees

The State of Michigan did not promise the SERA pension tax exemption out of charitable impulses, or as a gracious sovereign. The State promised those benefits as an

employer competing in the labor market with private employers for skilled professional employees. The SERA tax exemption is part of a contractual transaction.

The tax exemption component of the SERA retirement benefit is stated in straightforward terms:

> The right of a person to a pension, an annuity, a retirement allowance, any optional benefit, any other right accrued or accruing to any person under the provisions of this act, the various funds created by this act, and all money and investments and income of the funds, are exempt from any state, county, municipal, or other local tax. (Emphasis added)
>
> MCL 38.40 (prior to 2011 amendments)

This placement – in the SERA statute itself, rather than in the general income tax provisions, shows that the tax exemption benefit was a component of the promised SERA retirement system benefits.[22] As the Oregon Supreme Court noted in *Hughes v State of Oregon*, 838 P.2d 1018 (1992), the fact that a tax exemption provision is included in a retirement system statute, rather than in general tax sections of a state's compiled laws, indicates that the tax exemption is a contractual part of the promised pension benefit: "This case does not involve an isolated tax exemption enacted as a general statute on taxation. Rather [the tax exemption provision] is an integral part of the PERS statutes ..." *Hughes v. State of Oregon*, 838 P.2d at p. 1031. Similarly, as the North Carolina Supreme Court stated in finding that state's retirement statute contractually promised a tax exempt pensions:

> . . . the exemptions were contained in the aforementioned retirement statutes, alongside the requirements for and description of benefits, as opposed to being located among or within the statutes providing the individual income tax provisions or other tax statutes.

[22] The SERA tax exemption provision was duplicated in the Michigan statutory income tax provisions in 1967, but was set forth in SERA itself from the 1943 enactment of SERA through 2011.

Bailey v. State of North Carolina, 500 S.E.2d at p. 58. (emphasis added)

In contrast, the Colorado Court of Appeals, in denying an employee's pension claim, relied on the fact that a State employee's pension tax exemption appeared in the general taxation provisions of Colorado's statutes. The Colorado court, therefore, held that the tax exemption was not a contractual right of employees: "The tax exemption was not limited to PERA disability or retirement benefits; in fact, the exemption statute makes no reference to PERA benefits at whatsoever." *Spradling v. State of Colorado,* 870 P.2d 521, at pp. 523-524 (1994).

The placement of the SERA tax exemption in SERA itself, rather than in Michigan's general income tax provisions, as in *Spradling*, demonstrates that the SERA tax exemption was promised by the state as an employer. State employees working toward a SERA retirement reasonably understood that the tax exemption was a part of their pension benefit.

Moreover, the tax exemption was a component of the SERA pension statute at the time it was initially passed by the Michigan legislature in 1943. This is strong evidence that both parties – the state as the employer, and the workers the state employed - understood that the tax exemption was part of the contractually promised deferred compensation. See *Bailey v. State of North Carolina*, 500 S.E.2d, at p. 58, holding that the fact that the tax exemption was contained in that state's retirement system statutes "from their inception" indicated that it was part of the contractually promised benefit.

As noted above in the statement of facts, the State of Michigan – as an employer - consistently represented to its employees participating in SERA that their SERA pensions would be tax exempt. That history makes plain that employees covered by SERA

justifiably understood that the promised tax exemption was part of their compensation. The North Carolina Supreme Court noted a similar history in finding that a public pension tax exemption was a contractual obligation:

> . . . innumerable communications were made to plaintiff public employees with the intent of inducing individuals to either begin or continue employment. Moreover . . . innumerable communications were made to plaintiff public employees throughout their careers, both orally and in writing (including multiple unequivocal written statements in official publications and employee handbooks) that their retirement benefits would be exempt from state taxation.
>
> *Bailey v. State of North Carolina*, 500 S.E.2d, at p. 59

The State of Michigan promised the SERA pension tax exemption as an employer competing with private employers in labor market. As noted above in the Statement of Facts, Michigan governmental employees received salaries below the levels enjoyed by their private sector counterparts. The State of Michigan, finding it necessary to attract and retain skilled employees to provide crucial state services, enacted SERA as an inducement, to lure qualified professionals from the private sector. This is the reality, and the reason courts across the country have abandoned the theory that public employees pension benefits were offered as a gratuity.

> Here, in exchange for the inducement to and retention of employment, the State agreed to exempt for State taxation benefits derived from employee's retirement plans. This exemption was certainly for a public purpose, as it was a significant difference between governmental and comparable private employment that helped attract and keep quality public servants <u>in spite of the generally lower wages paid to state and local employees.</u>
>
> *Bailey v. State of North Carolina*, 500 S.E.2d, at p. 65.

The tax exemption component of the SERA deferred compensation promise gave Michigan, as an employer, an advantage over the private sector employers with which the State competed for the skilled employees the State needed. The pension tax exemption,

while valuable to employees, required no cash outlay by the State employer. Many other states, for the same reason, designed their employees' deferred compensation in this manner. As the Oregon Supreme court noted:

> Government obtained its employees' services less expensively because the gross cost of providing a more nearly adequate pension was lowered by the tax exempt nature of the benefit payments and of the contributions put in trust to purchase annuities payable at the time of each employee's future retirement....Less expense meant that less tax money was exacted from the taxpayers in general over past years to fund a public employee's salary and benefits.
>
> *Hughes v. Oregon,* 838 P.2d 1018 (1992), at p. 1042, N7.

The Supreme Court of North Carolina, in addressing exactly the question presented here found that a "reasonable person would have concluded from the totality of circumstances and communications made to plaintiff class member that the tax exemption was a term of the retirement benefits offered in exchange for public service to state and local governments." *Bailey v. State of North Carolina,* 500 S.E.2d 54 (1998), at p. 63, quoting trial court's jury instructions with approval. In Michigan, similarly, generations of State workers have begun employment with the state, labored for decades, and retired with the promise that the pension benefits they earned while employed would not be subject to state income tax.

B. The Contractual Nature of the SERA Tax Exemption is No Different than that of the Contractual Tax Exemptions Attached to Public Bonds Issued Under Michigan Statutes.

State of Michigan employees based their retirement planning on the benefit terms communicated to them by their employer and set forth in SERA. Rescinding the promised tax exemption after retirement, or after employees have worked decades and

accrued a pension benefit, violates the contractual bargain between those employees and their employer, the State of Michigan. The nature of that contractual obligation is no different than the contract the State enters into with investors in tax exempt bonds provided for by Michigan statutes. As set forth below, in Argument III of this Brief, numerous Michigan statutes provide for the sale of public bonds, and further provide that the income and/or interest on those bonds will be tax exempt. See, for example: MCL 141.1072, regarding issuance of public bonds under the Michigan Financing Shared Credit Rating Act, which states that "...interest and income from those bonds and notes, is exempt from all taxation of the state or a subdivision of the state."; and MCL 141.1375(4), regarding bonds issued under Michigan's Regional Convention Authority Act, which states that "All bonds... issued by an authority under this act, and the interest on the bonds ... are free from all taxation within this state, except for transfer and franchise taxes." These are binding contractual promises by the State of Michigan to purchasers of the tax exempt bonds.

The "are exempt" language seen in Michigan bond statutes mirrors the language in MCL 38.40, which similarly promises that SERA pensions "...are exempt from any state, county, municipal, or other local tax." See MCL 38.40, prior to 2011 amendments. (Emphasis added.)

The statutory promise the State of Michigan made to its employees, therefore, mirrors the State's statutory promise to purchasers of tax exempt bonds: Both the employees and the bondholders, in exchange for valuable consideration provided to the State of Michigan (years of service by the employees; the bond purchase price by the bondholders), were promised that they would receive a discrete stream of income

(pension payments to SERA participants; income and interest payments to bond holders), and that that income stream would be exempt from state and local taxation.

The Supreme Court of North Carolina drew exactly this parallel in holding that the State of North Carolina was bound by its promise of a tax exempt pension to its employees:

> The necessity for the State to be bound to its contractual obligations is clear when the Act in question is compared with the long established practice of the issuance of municipal bonds. The State regularly enters into contracts for tax exemptions in connection with its issuance of municipal bonds and the creation of obligations thereunder. In exchange for the lower rate of interest, the State agrees by statutory exemption to forgo taxation of the income or gain on the bonds. The State's policy of entering into a contract for a tax exemption clearly services a public purpose by inducing needed investment for important projects while paying a lower than market rate of interest.
>
> The State's action here in changing the taxability of vested retirement benefits is not different than if the State issued tax free bonds, collected hundreds of millions of dollars for their purchase, and then ...repealed investor's tax-free interest and capital gains advantages.
>
> *Bailey v. State of North Carolina*, 500 S.E.2d, at p. 65.
>
> Once the commitment is made, and its derivative benefits enjoyed by the State, the State can no more remove this condition than it can tax the interest and gain of municipal bond holders.
>
> Such a "change in the blueprint" is not acceptable in a government guided by notions of fairness, consent, and mutual respect between government and man...
>
> *Bailey, Id.,* at pp. 65-66.

This reasoning is equally compelling here. There can be no principled distinction between the tax exemptions promised to investors in Michigan's public bonds, and the tax exemption promised since 1943 to State workers in exchange for their service.

C. The Cases Cited in the Brief of the Attorney General in Support of Validity are Not Persuasive.

The Attorney General cites *Spradling v. Colorado Dept. of Revenue* 870 P.2d 521 (1994) in support of his argument that the SERA tax exemption should not be considered a part of the contractually protected SERA deferred compensation.[23] *Spradling*, however, supports the opposite result. In *Spradling*, the court held that governmental pension statutes created contractual rights, and, to determine whether those pension rights included a tax exemption, examined "...the statutory language and the surrounding circumstances..." *Spradling*, p. 523. The *Spradling* court held that the tax exemption was not part of the pension benefit because it was included in general income tax provisions, rather than the Colorado state retirement system statute:

> This tax exemption was not limited to PERA disability or retirement benefits; in fact, the exemption statute makes no reference to PERA benefits whatsoever.
>
> *Spradling*, p. 523-524

The *Spradling* decision underscores the essential distinction between tax exemptions set forth in general tax statutes, which create no contractual right, and tax exemptions a government employer promises, *as an employer*, in a separate statute that provides deferred compensation to its employees.

The Attorney General also cites an Ohio case, *Herrick v. Lindley,* 391 N.E.2d 729 (1979), which held that a tax exemption provided with respect to an Ohio state teachers retirement system was not contractual, despite the fact that the tax exemption appears to have been included in the retirement system statute. The analysis in *Herrick* is incomplete, however, because it did not address the fundamental questions which would determine whether the circumstances indicated that a contract had been formed, of whether the tax exemption was part the employees' deferred compensation, whether it

[23] See Attorney General Brief in Support of Validity, p. 31.

was used to recruit and retain employees, or whether employees reasonably understood the pension tax exemption to be part of their deferred compensation. Amicus UAW therefore urges this court to follow the better reasoned decisions cited above.

III. THE "POWER OF TAXATON" CLAUSE AT ARTICLE 9, § 2 OF THE MICHIGAN CONSTITUTION DOES NOT PROHIBIT THE MCL 38.40 TAX EXEMPTION PROMISED TO SERA RETIREES.

The Brief of Attorney General in Support of Validity asserts that recognition of the tax exemption component of the promised SERA pension benefit would violate Article 9, § 2 of the Michigan Constitution.[24] As set forth below, however, both this Court and the Michigan Legislature have recognized that Article 9, § 2 does not prohibit limited tax exemptions granted by the State legislature for a public purpose.

Article 2, § 9 provides as follows:

> The power of taxation shall never be surrendered, suspended, or contracted away.

The Attorney General's argument misunderstands the difference between a statutory grant of complete tax *immunity* which would be prohibited by Article 9 § 2, and the commonplace practice of granting a limited tax *exemption* with respect to a discrete stream of payments.

As the Attorney General's Brief in support of Validity acknowledges, the Article 9, § 2 "power of taxation" provision was adopted to prohibit abuses which occurred during the nineteenth century, when private corporations – typically railroads, mining companies, insurance companies, and banks – obtained special legislation granting them complete immunity from taxation. The cases cited in the Attorney General's Brief in Support of Validity illustrate those abuses. See, for example, *State Bank of Ohio v. Koop,* 57 U.S. 369 (16 How), at p. 384 (1853), in which the State of Ohio granted a bank – and its stockholders – a perpetual immunity from "all taxes," See also *Levin v Baltimore & O.R. CO.,* 17 A.2d 101, at p. 104 (1941), enforcing 114-year old legislation granting a

[24] Brief of Attorney General in Support of Validity, pp. 18-20.

railroad company complete tax immunity: "...shall be exempt from the imposition of any tax or burthen ..."

As the Supreme Court of Arizona explained in examining a "power of taxation" constitutional provision identical to Article 9, § 2 of the Michigan Constitution, these constitutional protections were adopted because of "...concern about giant corporations evading taxation..." and the "strong grip on the political process" exercised by those corporations during the nineteenth century. See *Valencia Energy Co. v. Arizona Dept. of Revenue*, 959 P.2d 1256, at p. 1264 (Arizona, 1998), quoting from John Leshy, The Making of the Arizona Constitution, 20 Ariz. St. L. J. 1, 11-12 (1988). These State tax immunity grants prospectively forbade any legislation levying any tax on the favored corporation. The enactments were often perpetual, forbidding taxation forever.

Thus, the purpose of the "power of taxation" clause in the Michigan Constitution is to prohibit the State Legislature from granting private corporations or individuals a perpetual and complete "immunity" from all taxation. Article 9, § 2 of the Michigan Constitution does not, however, prohibit the common legislative practice of granting a limited tax exemption in furtherance of a public purpose.

The distinction between an unconstitutional grant of complete tax immunity and a permitted grant of a limited tax exemption is illustrated by tax exempt bonds, which have been routinely granted by the Michigan Legislature. Such bonds, issued for a public purpose, are sold to investors with a promise that the future income stream derived from the bond will be tax exempt. Tax exempt bonds are, therefore, precisely analogous to the statutory tax exemption promised with respect to the discrete future stream of pension payments promised to retirees by the SERA retirement system.

As the Michigan Supreme Court held in *W.A. Foote Memorial Hospital v. City of Jackson*, 390 Mich. 193, 211 N.W.2d 649 (1973) limited tax exemptions do not violate the Article 9, § 2 "power of taxation" clause. The *Foote* case involved a Michigan statute that, "...with exceptions, gives a State and local tax exemption to holders of notes and bonds issued by authorities pursuant to the act." *Foote*, pp. 214-215. The Michigan Supreme Court, rejecting a claim that the statute was an unconstitutional "surrender" of the State taxing power in violation of Article 9, § 2, held that, to the contrary:

> Rather than abandoning its power of taxation, the Legislature has acted affirmatively and has exercised its power and discretion as explicitly authorized in art 9, § 3 by granting an exemption "by law"...
>
> *Foote Hospital v. City of Jackson,* 390 Mich. at p. 215.

The Michigan Legislature has on numerous occasions enacted provisions promising a tax exemption on a future stream of bond income. See, for example: MCL 141.1072, regarding issuance of public bonds under the Michigan Financing Shared Credit Rating Act, and stating that "...interest on and income from those bonds and notes, is exempt from all taxation of the state or a subdivision of the state."; and MCL 141.1375(4), regarding bonds issued under Michigan's Regional Convention Authority Act, and stating that "All bonds... issued by an authority under this act, and the interest on the bonds ... are free and exempt from all taxation within this state, except for transfer and franchise taxes."

These statutory tax exemptions promises are contractual. The State cannot repeal the tax exemption with respect to these bonds after investors have paid for them with the statutory assurance that the bond income and/or interest will be tax exempt. See *United States Trust Co. v. New Jersey,* 431 U.S. 1, at p. 24, n. 4, noting with approval that: "...a tax on municipal bonds was held unconstitutional because its effect was to reduce the

contractual rate of interest.", citing *Murray v. Charleston*, 96 U.S. 432, at pp. 443-446 (1878). The tax exemption promised to State employees in § 40 of SERA is, for purposes of the "power of taxation" clause at Article 9, § 2 of the Michigan Constitution, no different than the tax exemption promised to the holders of tax exempt bonds.. The SERA pension tax exemption applies only to a discrete and temporary stream of future income – the pension payments earned during employment and received – until death - from the SERA retirement system. This is not a tax immunity. Unlike the "giant corporations" who were the recipients of blanket tax immunity during the nineteenth century, retirees receiving a pension from the SERA retirement system remain obligated to pay property taxes, sales taxes, business taxes, and income taxes on all income other than pension payments from the SERA retirement system. Moreover, the SERA tax exemption is not perpetual: the legislature is free to amend SERA to tax pension rights earned after the effective date of any prospective enactment.

As with the tax exempt bond statutes, the tax exempt pension provision in MCL 38.40 serves a public purpose. The tax exempt bonds at issue in *Foote v. City of Jackson*, *Supra*, for example, served the public purpose of encouraging hospital construction: the tax exemption was enacted to make the hospital bonds attractive to investors. The SERA pension tax exemption, similarly, was enacted to make State employment attractive to the professionals Michigan needed to provide essential State services to its citizens.

The Supreme Court of North Carolina examined facts nearly identical to those presented here in *Bailey v. North Carolina*, 500 S.E.2d 54 (1998). As here, the North Carolina legislature had enacted a comprehensive state employee pension system that included, as a part of the promised compensation, a tax exemption on pension payments from the state pension system. Also as here, the North Carolina State Constitution

contained a "power of taxation" provision, similar to Article 9, § 2 of the Michigan Constitution, which provided that "[t]he power of taxation. . . shall never be surrendered, suspended, or contracted away." The North Carolina Supreme Court rejected an attempt by a subsequent legislature to rescind the promised tax exemption, and specifically rejected an argument that the "power of taxation" clause in the North Carolina Constitution prohibited the pension tax exemption.

The North Carolina Supreme court first noted that the state could not, after reaping the benefits of the promised tax exemption, later argue that the exemption violated the state constitution:

> [t]he rule is well settled that one who voluntarily proceeds under a statute and claims benefits thereby conferred will not be heard to question its constitutionality in order to avoid its burdens.
>
> *Bailey v. State of North Carolina, Id.,* 500 S.E.2d, at p. 64, citing 11 Am.Jur *Constitutional Law* § 123, at 767 (1937)
>
> ...the State created the exemption and then proceeded for decades to represent it as a portion of retirement benefits and to reap its contractual benefits. . .the State used these representations as inducement to employment with the State, and employees relied on these representations in consideration of many years valuable service to and with the State. The State's attempt to find shelter in the North Carolina Constitution must be compelling indeed after such a long history of accepting the benefits of the extension of the exemption in question. We find no such compelling case here.
>
> *Bailey v. State of North Carolina*, at p. 64

The North Carolina Supreme Court then noted the similarity between the limited tax exemption provided for in the state retirement system pension statute, and the common legislative practice of granting an tax exemption on a future stream of income from publicly issued tax free bonds:

> The necessity for the State to be bound to its contractual obligations is clear when the Act in question is compared with the long-established practice of the issuance of municipal bonds. The

> State regularly enters into contracts for tax exemptions in connection with its issuance of municipal bonds and the creation of its obligations thereunder. In exchange for paying a lower rate of interest, the State agrees by statutory exemption to forgo taxation of the income or gain on the bonds. The States policy of entering into a contract for a tax exemption clearly serves a public purpose by inducing needed investment for important projects while paying a lower-than-market rate of interest.
>
> *Bailey v. State of North Carolina, Id.,* 500 S.E.2d, at p. 65.

The North Carolina Supreme Court then went on to note that a promise of a tax exemption on a public employee pensions is exactly the same, in principle, as a tax exemption on public bonds:

> The State's action here in changing the taxability of vested retirement benefits is no different than if the State issued tax free bonds, collected hundreds of millions of dollars for their purchase, and then retrospectively repealed investors' tax free' interest and capital gains advantages. However, under application of defendants' premise, this is precisely what the State could do. The basis for prohibiting such action is fundamental fairness.
>
> *Bailey v. State of North Carolina, Id.,* 500 S.E. 2d, at p. 65

Just as Article 9, § 2 of the Michigan Constitution does not prohibit a limited tax exemption for a public purpose with respect to a future stream of bond payments, that "power of taxation" clause also does not prohibit a limited tax exemption with respect to a future stream of pension payments from the SERA retirement system.

The Brief of Attorney General in Support of Validity cites decisions from other states in support of this argument that Article 9, § 2 of the Michigan Constitution prohibits the SERA pension tax exemption. See, for example, *Blair v. State Tax Assessor*, 485 A.2d 957 (Maine, 1984) which, in a one-paragraph analysis, ruled that recognition of a pension tax exemption would violate a "power of taxation" clause in the Maine Constitution. Those decisions, however, reflect a view that is contrary to

Michigan's approach: Michigan permits limited, public purpose tax exemptions on future income streams (see above).[25]

The Attorney General's Brief in Support of Validity also asserts that, because Article 9, § 4 the Michigan Constitution requires that charitable and educational organizations be tax exempt, all other tax exemptions must be unconstitutional. Clearly, that is not the case. As noted above, Michigan's statutes are replete with tax exemptions which serve various public purposes other than charitable and educational. A Michigan law granting an exception to otherwise applicable taxes must be one of thee types:

1) a complete tax immunity granted to private corporations or individuals (*prohibited* by Article 9, § 2);

2) a tax exemption provided to educational and charitable institutions (*required* by Article 9, § 3); and

3) a limited tax exemption granted by the legislature to further a public purpose (*permitted* under the State's general power of taxation, as held by the Michigan Supreme Court in *W.A. Foote v. City of Jackson*, supra).

The limited tax exemption applicable to earned pensions under SERA is clearly of the third category. It is limited in scope, may be revoked by the legislature with respect

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[25] Similarly, see also *Parrish v. Employees Retirement System of* Georgia, 398 S.E.2d 353 at p. 354 (Ga. 1990), which relied on a prior Georgia Supreme Court decision, *Felton v. McArthur*, 160 S.E. 419 (1931), at p. 423, which had previously held that a "power of taxation" clause in the Georgia constitution was intended to "...deny to the Legislature the power to grant exemptions from taxation..." (emphasis added). See also *Sheehy v. Public Employees Retirement Division* 864 P.2d 766 (Montana, 1993) which examined a State constitutional provision different in one important respect than Article 9, § 2 of the Michigan Constitution: the Montana constitutional provision stated that "The *power to tax* shall never be surrendered . . ." (See Article 8, § 2 of the Montana Constitution. In contrast, Article 9, § 2 of the Michigan Constitution states that the "*power of taxation*" shall never be surrendered. As the Michigan Supreme Court held in *W.A. Foote,* the "power of taxation" includes the power of the legislature to accomplish public purposes by granting limited exemptions. In contrast, the "power to tax" in the Montana constitutional provision was read to include only the power to tax, not the power to exempt.

to pension rights earned in the future, and furthers a vital public interest – the need to persuade qualified professionals to work in State government.

IV. 2011 PA 38 IMPAIRS THE STATE'S CONTRACTUAL OBLIGATION TO PROVIDE THE SERA MCL 38.40 PENSION TAX EXEMPTION, IN VIOLATION OF ARTICLE I, § 10 OF THE U.S. CONSTITUTION AND ARTICLE I, § 10 OF THE MICHIGAN CONSTITUTION

As set forth in Arguments I, II, and III of this brief, SERA pension tax exemption enacted in 1943, at MCL 38.40 created a contractual deferred compensation obligation to State of Michigan employees participating in the SERA retirement system. The partial termination of that contractual pension tax exemption in 2011 violates the prohibition against impairment of contracts set forth in Article 1, § 10 of the U.S. Constitution and Article 1, § 10 of the Michigan Constitution. The UAW, rather than burden this Court repetitive argument, adopts the well-stated argument on this point set forth in the MSERA Amicus Brief, at pp. 34-44.

CONCLUSION

The UAW asks that this court find, as an advisory opinion, that: 1) SERA creates a contractual obligation to provide the pension tax exemption previously set forth in MCL 38.40, and 2) 2011 PA 38, to the extent that it eliminates that tax exemption, impermissibly impairs that contractual obligation in violation of Article 1, § 10 of the U.S. and Michigan Constitutions.

Michael F. Saggau (P35326)
Associate General Counsel
International Union, UAW
8000 E. Jefferson Avenue
Detroit, MI 48214
(313) 926-5216
(313) 926-5240 (fax)
msaggau@uaw.net

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